

ST 01-18

Tax Type: Sales Tax

**Issue: Audit Methodologies and/or Other Computational Issues
Tangible Personal Property**

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS**

THE DEPARTMENT OF REVENUE)	Docket #
OF THE STATE OF ILLINOIS)	IBT #
v.)	
)	
ABC, INC.)	Barbara S. Rowe
Taxpayer)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Robert J. Allison, Allison and Allison, P.C., for ABC, Inc. Mr. Charles Hickman, Special Assistant Attorney General for the Illinois Department of Revenue.

Synopsis:

This matter comes on for hearing pursuant to the timely protest of ABC, Inc. (hereinafter referred to as the "taxpayer") to Notices of Tax Liability issued for the period of January 1995 through December 1996. The issues in this matter include, (1) whether the Department's audit findings were in error; (2) whether the Department's *prima facie* case was rebutted; and (3) whether the purchase of the copier and the XYZ Associates transactions are subject to taxation. After reviewing the record, it is recommended that the liability in question be cancelled except for the tax attributable to the XYZ Associates transactions and the tax due on the purchase of the copier. In support thereof, I make the following findings and conclusions in accordance with the requirements of Section 100/10-50 of the Administrative Procedure Act (5 ILCS 100/10-50).

FINDINGS OF FACT:

1. The *prima facie* case of the Department was established by the admission into evidence of the SC-10-K Audit Correction and/or Determination of Tax Due issued by the Illinois Department of Revenue (hereinafter referred to as the "Department") on November 5, 1998, for Retailers' Occupation Tax (hereinafter referred to as "ROT") liability of the taxpayer in the amount of \$83,078.00 including taxes and penalty. (Dept. Ex. No. 1; Tr. pp. 6,35)

2. The taxpayer is engaged in the business of graphic arts design. (Tr. p. 25)

3. The taxpayer was registered with the Department and collected and remitted tax on its retail sales, and self assessed Service Occupation Tax (hereinafter referred to as "SOT") on portions of its purchases of tangible personal property that was transferred incident to the sale of service. (Dept. Memorandum)

4. At the audit of the taxpayer, the auditor requested purchase invoices, sales tickets, sales journals, sales summary sheets, and the general accounting records such as a general ledger, sales journals, and sales and income tax returns for the audit period of January 1995 through 1996. The auditor was given sales tickets for February 1995 through April 1996, sales summary sheets for February 1995 through June 1996, sales tax returns- ST-1s for January 1995 through June 1996, and purchase invoices for 1995 and 1996. Most of the invoices showed on their face that graphic arts products were being sold. (Tr. pp. 13, 25-28)

5. The auditor identified six areas of controversy:

- a) Deductions overstated on p. 1 of ST-1 for 5/96, tax amount \$1,399.00;
- b) Deductions claimed in error-no proof of exemption - test month 5/95, tax amount \$67,122.00;
- c) Consumable supplies purchased - no tax paid to vendors, tax amount \$1,774.00;
- d) Fixed asset purchased - no tax paid to vendor, tax amount \$219.00;
- e) Use tax base understated on ST-1's filed for 6/96 & 7/96, tax amount \$1,546.00; and
- f) Material portion of sales to XYZ Assoc. - as compiled by the taxpayer, tax amount \$179.00.(Dept. Ex. No. 2)

6. The Department concedes the first issue of controversy, the deductions overstated on page 1 of the ST-1 for May 1995 in the amount of \$1,399.00. (Dept. Memorandum, Tr. p. 5¹)

7. The auditor attempted to perform a detailed analysis of the taxpayer's books and records for May of 1995. He had a difficult time reconciling the sales summary sheets with invoices provided. The auditor did not attempt to reconcile the invoices to the ST-1s submitted to the Department. He did not consult the taxpayer for an explanation of the summary sheets; nor did he consult the taxpayer if he had difficulty deciphering numbers. The auditor used May 1995 as the test month for the audit. He then projected the May computations over the liability period. The Department picked up the full amount of the transactions in the test month as taxable under the ROTA. The custom printing issue amounts to \$67,122.00 out of the proposed adjustment of \$72,239.00 and is the major issue herein. (Dept. Ex. No. 2; Tr. pp. 7,16-18, 20-24, 31-33)

8. The Department concedes that to the extent that the taxpayer was able to substantiate the art production and copying nature of its sales, the taxpayer was engaged in a service occupation. Therefore, the taxpayer's obligation should be determined under the Illinois Service Occupation Tax Act (hereinafter referred to as the "SOTA"), 35 ILCS 115/1 *et seq.* (Dept. Memorandum)

9. The taxpayer listed the graphic arts transactions under the business exempt line of the ST-1. There is no specific line on the ST-1 or worksheet for the ST-1 for the exemption for graphic arts production. The taxpayer specifies the exempt transactions on its summary sheets and then combines them on the ST-1 worksheet. All of the taxpayer's receipts are shown on the summary sheets, with the top sheet reflecting the totals of each category for the month. The auditor did not give the taxpayer any credit for the graphic art exempt/designer art deductions. (Taxpayer's Ex. Nos. 1 & 4; Tr. pp. 24-25, 30-41)

¹ The transcript lists the amount as \$1,299.00; however, the summary analysis and Dept. Memorandum show it to be \$1,399.00.

10. The taxpayer established that it was in the business of custom ordered printing through testimony and documentary evidence. (Taxpayer's Ex. Nos. 1- 5; Tr. pp. 36-92)

11. The spreadsheets used by the taxpayer were its documentation to support the calculations that he uses to self-assess tax and fill out the ST-1. The auditor thought the spreadsheets were simply sales summaries. The spreadsheets have categories for: exemptions, broken down into interstate, not-for-profit, and business exempt; service; shipping; postage; taxable amount; tax collected; and resale. The taxpayer writes up a sales slip/invoice for each sale. The taxpayer enters the dollar amounts for its receipts on the spreadsheet the day the money is received. The taxpayer self assesses tax by the distribution of sales on the recap sheet. The sales that are not taxable due to exemptions are taken as a percentage of the total sales made by the taxpayer. That percentage is used by the taxpayer to self assess SOT on the materials it purchases and incorporates into its custom printing jobs. The taxpayer collects and remits tax on the sales of non-custom printing items and products. (Taxpayer's Ex. Nos. 1, 3 & 4; Tr. pp. 32, 37-94, 98-100, 105)

12. The taxpayer supplied books and records and after the hearing the Department, in examining the invoices and testimony given by the taxpayer with the Global Taxable Exceptions found by the auditor, determined that of the \$41,209.00 of the exceptions picked up by the auditor for the test period, May 1995, \$35,244.00 are service transactions subject to the SOTA. (Tr. pp. 46-94; Dept. Memorandum)

13. The taxpayer maintains invoices and spreadsheets for each month of business. The auditor looked at the ST-1s that were filed for June 1996 and July 1996 and determined that the tax reported for those months were substantially less than previous months. The auditor took the average of the prior 17 previous months and assessed tax on the difference of the average and the ST-1s submitted for those two months. (Tr. pp. 14-15, 29)

14. The auditor requested summary sheets or other backup as to how the numbers

were computed for June and July 1996. The auditor did not receive the information for July 1996². (Tr. p. 29-30, 27-28)

15. XYZ Associates is a computer training operation. The taxpayer thought the sales to XYZ were sales for resale. After the auditor visited the taxpayer, the taxpayer checked with the management of XYZ and discovered that the sales were not for resale. The taxpayer pre-printed sheets and placed them in ring binders for XYZ. The spreadsheets of the taxpayer reflected the sales to XYZ as sales for resale. The sales should have been listed in the graphic arts exempt category. The taxpayer failed to self assess tax on the materials used on the sales to XYZ. (Tr. pp. 94-96)

16. In one exception, the Department erroneously listed as taxable a \$70.00 dollar transaction, invoice 216699. The invoice shows that it was a retail sale and tax was collected. The \$70.00 figure should be removed from the taxable exception amount. (Dept. Memorandum)

17. The taxpayer agrees that it is liable for the tax liabilities of the XYZ Associates transactions. The transaction amount for XYZ, as shown on the global exceptions list, is \$2,856.07. The taxpayer also agrees that it is liable for taxes on the Sharp copier, purchase price, \$ 3,500.00. (Tr. pp. 109-110; Taxpayer Memorandum)

18. The taxpayer calculated the material cost on most of the invoices for May 1995 and for 99% of them the cost of materials was under 10% of the total sales price. (Tr. p. 93)

Conclusions of Law:

Section 2 of the ROTA, 35 ILCS 120/2, imposes a tax upon persons engaged in the business of selling tangible personal property at retail. The Department performed an audit of the taxpayer's business and issued notices of tax liability for ROT for the period of January 1995

² At the hearing, the auditor testified that he did not receive summary sheets for both those time periods. (Tr. p. 29). At the deposition of the auditor, he stated that he received sales tickets for February of '95 through April of '96, sales summary sheets for February of '95 through June of '96, sales tax returns, ST-1s for January of '95 through June of '96, and purchase invoices for '95 and '96. (Tr. pp. 26-28)

through December 1996. The taxpayer protested the imposition of the tax and requested a hearing. Pursuant to 35 ILCS 120/4, the Correction of Returns, submitted as Dept. Ex. Nos. 1 through 4, are *prima facie* correct and constitute *prima facie* evidence of the correctness of the amount of tax due as shown thereon. See also, A.R. Barnes & Company v. Department of Revenue, 173 Ill.App.3d 826 (1st Dist. 1988). Once the Department establishes the *prima facie* correctness of the amount of tax due by the admission into evidence of the Correction of Returns, the burden shifts to the taxpayer to show such determination is incorrect. In order to overcome the presumption of validity attached to the Department's corrected returns, the taxpayer must produce competent evidence, identified with its books and records, showing that the Department's returns are incorrect. Copilevitz v. Department of Revenue, 41 Ill.2d 154 (1968).

Gross receipts from proceeds from the sale of certain tangible personal property are exempt from the tax imposed by the ROTA. 35 ILCS 120/2-5. The Department has promulgated rules to help explain the exemptions. Regarding the projection computation done by the auditor for the test period of May 1995, in which the Department determined that the taxpayer sold tangible personal property as a retailer, the rule at issue is entitled "Personalizing Tangible Personal Property". It is found at 86 Admin. Code ch I, §130.1995, and states:

a) When the Tax applies

- 1) Thermometers, pencils, pens, mirrors, silverware, notebooks, diaries, baby books * * * have intrinsic usefulness and general utility and so have commercial value (i.e., value to persons other than the purchaser) notwithstanding the fact that such items are personalized for the purchaser by the seller by printing, engraving, or some other process by means of which the purchaser's name, monogram, trade-mark or special advertising matter is placed upon the article for the purchaser by the seller.

* * *

b) When the Tax Does Not Apply

- 1) Sellers of personalized business calling cards, letterheads, envelopes, labels, name plates, badges, medallions and the like do not incur Retailers' Occupation Tax liability on their receipts from such sales because they are primarily engaged in a service occupation in producing or procuring such items, which have no commercial value for their customers. * * *

The taxpayer was registered with the Department and timely paid its tax liabilities for the cost of the materials incorporated into its custom print jobs and tax on the sales of tangible personal property sold at retail. At the audit, the Department picked up the full amount of the transactions in the test month of May 1995 as taxable at the ROT rate. The Department now concedes that the taxpayer was engaged in the business of graphic arts design. After the hearing and its analysis of the transcript and the evidence presented, the Department also concedes that, to the extent that the taxpayer was able to substantiate the art production and copying nature of its sales, the taxpayer was engaged in a service occupation and the taxpayer's obligation should be determined under the SOTA which is what the taxpayer did when it filed its returns.

The amount of tax fixed by the Department according to its best judgment and information is *prima facie* correct. Once the *prima facie* case is established, the taxpayer has the burden of proving by competent evidence that the proposed assessment is incorrect and when the evidence presented by the taxpayer is not so inconsistent or improbable in itself to be unworthy of belief, the burden then shifts to the Department to prove its case by a preponderance of the evidence. Fillichio v. Department of Revenue, 115 Ill.2d 327 (1958)

The taxpayer's president testified invoice by invoice to the types of printing that each of the invoices represented. The invoices were for May 1995, the test period set by the Department. The jobs described were custom printing for the purchasers. The credible testimony of the taxpayer's representative correlated the invoices to the summary sheet for May 1995. The summary sheet was the document that the taxpayer's employees relied upon to fill out the ST-1 sales tax return that was submitted to the Department.

After the hearing, the Department reviewed the invoices with the global taxable exceptions found by the auditor and determined that of the \$41,209.00 amount of exceptions picked up as fully taxable, \$35,244.00 are service transactions subject to SOT rather than ROT.

Therefore, the Department determined that the taxpayer should be liable for tax under the SOTA rather than the ROTA.

The taxpayer asserts it overcame the Department's *prima facie* case with its invoices, spreadsheet, and corresponding testimony showing the interrelationship of that information with the May 1995 ST-1 tax return. No other period is relevant because the auditor chose May 1995 as the test month and projected those figures over the entire audit period. The Department states that in order to overcome the *prima facie* case of the Department, the burden is on the taxpayer to produce sufficient, competent evidence, identified with the taxpayer's books and records showing that the Department's determination is incorrect. Worthington v. Department of Revenue, 96 Ill.App.3d 1132 (2nd Dist. 1981), Barnes v. Department of Revenue, 173 Ill.App.3d 826 (1st Dist. 1988). That statement of the Department is correct.

In Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill.App.3d 203 (1st Dist. 1991) the appellate court discussed what is necessary to overcome the Department's *prima facie* case. Relying on Elkay Manufacturing Co. v. Sweet, 202 Ill.App.3d 466, 472 (1st Dist. 1990), the court concluded that a taxpayer must present more than its testimony denying the accuracy of the assessments but must present sufficient documentary support for its assertions.

The court in Mel-Park discussed the need to keep sufficient books and records to support the claim of deduction. Mel-Park destroyed its source documents once it recorded the figures elsewhere and threw away the tally sheets of the costs. The court found that the *prima facie* case of the Department had not been overcome and that the audit was not defective. In doing so, the court in Mel-Park at 216-17 stated:

The Department is required only to meet a minimum standard of reasonableness when correcting taxpayers' returns. Fillichio v. Department of Revenue, 15 Ill.2d 327 (1958) While the Department may not ignore the taxpayer's records when they are complete and accurate, and substitute its judgment based upon general estimates Goldfarb v. Department of Revenue, 411 Ill. 573 (1952), the records submitted to the auditor in the case at bar

were not sufficiently specific * * * . As a matter of policy, the taxpayer should not be able, in effect, to elect a less precise method of supporting its statement of gross receipts when the law clearly mandates that accurate records of actual sales receipts be kept. Ill. Rev. Stat. 1989, ch. 120, par. 446; Copilevitz v. Department of Revenue, 41 Ill.2d 154, 157 (1968).

To overcome the Department's prima facie case, a taxpayer must present more than its testimony documenting the accuracy of the assessments, but must present sufficient documentary support for its assertions. Elkay Manufacturing Co. v. Sweet, 202 Ill.App.3d 466,472 (1990). As a general matter, and leaving aside casual individual sales, all sales of tangible personal property are taxable unless the taxpayer produces evidence identified with its books and records to establish its claim of non-liability. Central Furniture Mart, Inc. v. Johnson, 157 Ill.App.3d 907 (1987).

The taxpayer in Mel-Park Drugs had destroyed the source documents it used. The taxpayer herein produced the source documents at the hearing, namely the invoices for May 1995, the spreadsheet which detailed the gross sales and listed them in the categories that were or were not taxable, and the ST-1 Sales and Use Tax return that had been submitted to the Department for May 1995. The taxpayer takes the numbers from the spreadsheet and transfers them to the ST-1 worksheet for Line 2. As the Department's worksheet does not have lines that exactly correspond to the taxpayer's spreadsheet, two categories, "service" and "business exempt", are combined for line 9(c) of the Department's worksheet and are identified as "copying and printing" - "the nontaxable portion from sales of service". The taxpayer then combines the total deductions from the worksheet for line 2, entitled "deductions", of the ST-1 and transfers the figure to page one of the ST-1.

The Department concedes that the taxpayer correctly accounted for over 85% of the invoices for the test period, May 1995. The figures from the spreadsheet for that period match the ones on the worksheet and the ST-1 submitted to the Department.

The Department's Memorandum also states that "[T]his taxpayer, to overcome the Department's *prima facie* [case] with regard to the issue of the manner in which it was entitled to

report its SOT liability, had the obligation of producing sufficient, competent evidence, identified with its books and records, showing that it was a de minimus serviceman."³ I disagree with this statement of the Department.

The Department's *prima facie* case sets forth ROT liability for this taxpayer. At the hearing, taxpayer presented books, records, and credible oral testimony to establish it was not liable for ROT, but rather for SOT, which is the tax it reported on its monthly returns, and the tax it remitted moneys for to the Department.

Following the hearing, the Department, in fact, conceded that its assessments based on ROT liability are incorrect, and that, as taxpayer represented in the first instance, on its returns, the SOT is the correct basis for taxpayer's liability. Clearly, the taxpayer rebutted the Department's *prima facie* case. Once that happens, the burden shifts to the Department to prove its case by a preponderance of the evidence. Goldfarb v. Department of Revenue, 411 Ill. 573 (1952). The Department failed to do that.

The Department contends that the taxpayer incorrectly reported its SOT liability. The taxpayer calculated the material cost on most of the invoices for May 1995 and for 99% of them the material cost was under 10% of the total. The taxpayer figured a percentage to determine the amount to self-assess for SOT on the materials used in its custom printing jobs. The Department has not supplied any additional evidence or documentation to show why the taxpayer's computations are incorrect.

In addition, prior to the hearing, the Department alleged that the deductions were overstated on page 1 of the ST-1 for May 1996. At the hearing the Department conceded that those deductions were not overstated.

It is therefore recommended that the liability at issue be cancelled except for the taxes due on the transactions attributable to XYZ Associates and due on the Sharp copier. The

³ Memorandum of the Department p. 4.

Taxpayer agrees it is liable for the taxes on the transactions and copier.

Respectfully Submitted:

Date: August 30, 2001

Barbara S. Rowe
Administrative Law Judge